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IN THE

Supreme Court of the United States

October Term, 1966

No. 1414 /83

HENRY ROY,

Petitioner,

vs.

UNITED STATES OF AMERICA,

Respondent.

Petition for Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit, Judgment Affirming Judgment of the United States District Court for the Southern District of California, Central Division.

BRUCE I. HOCHMAN and
HARVEY D. TACK,
6222 Wilshire Boulevard,
Los Angeles, Calif. 90048,
Attorneys for Petitioner.

Of Counsel:
BURTON MARKS,
8447 Wilshire Boulevard,
Suite 217,
Beverly Hills, Calif. 90211.

Parker & Son, Inc., Law Printers, Los Angeles. Phone MA. 6-9171.

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Petition for Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit, Judgment Affirming Judgment of the United States District Court for the Southern District of California, Central Division.

This is a petition of Henry Roy for Writ of Certiorari to review the judgment and order made by the United States Court of Appeals for the Ninth Circuit on April 5, 1967, affirming the judgment against petitioner made and entered by the United States District Court for the Southern District of California, Central Division, on May 2, 1966, after the Court found the defendant guilty on all three counts of the indictment on March 17, 1966. Petitioner was sentenced to serve a period of six months in custody and to pay a fine of $30,000.00.

The District Court's opinion was not reported. Copies of the affirming judgment and of the opinion of the United States Court of Appeals for the Ninth Circuit, which is as yet officially unreported, are attached (Appendices A and B, respectively). The Circuit Court opinion is reported in 19 A.F.T.R. 2d 1287. On May 4, 1967, the Honorable William O. Douglas, Associate Justice of the Supreme Court of the United States, issued an Order Extending Time to File Petition for Writ of Certiorari, extending said time to May 20, 1967 (Appendix C).

Jurisdiction.

The United States District Court for the Southern District of California, Central Division, had jurisdiction of this cause by virtue of Title 18, United States Code, Sec. 3231; Title 26, United States Code, Sec. 7201; Rule 18 of the Federal Rules of Criminal Procedure.

The Circuit Court of Appeals for the Ninth Circuit had jurisdiction under Title 28, United States Code, Secs. 1291 and 1294(1), and Rule 37(a) of the Federal Rules of Criminal Procedure.

This Court has jurisdiction under Title 28, United States Code, Sec. 1254(1) to review the judgment in question.

Statement of the Case.

On April 7, 1965, petitioner was indicted for violation of Sec. 7201 of the Internal Revenue Code of 1954, as amended (26 U.S.C. 7201). The indictment

charged that petitioner had understated his taxable income by $81,887.60, $113,861.07, and $158,535.21 for the calendar years 1958, 1959, and 1960, respectively. This understatement, the indictment charged, resulted in an additional federal income tax liability for the above years in the amounts of $52,206.39, $77,182.73, and $115,497.70. The alleged omitted income was determined by the Government by the bank deposit method of recomputing taxable income.

Petitioner plead not guilty to all three counts of said indictment and was tried by the United States District Court for the Southern District of California, sitting without a jury, on March 15-17, 1966. The court found petitioner guilty on all three counts of the indictment. Thereafter, the petitioner timely moved for a new trial, or in the alternative for a judgment of acquittal. These motions were denied by the Court. Judgment of the District Court was entered on May 2, 1966, sentencing petitioner to serve a period of six months in custody and to pay a fine of $30,000.00.

On April 5, 1967, the United States Court of Appeals for the Ninth Circuit affirmed the judgment of conviction. On May 4, 1967, the Honorable William O. Douglas, Associate Justice of the Supreme Court of the United States, issued an Order Extending Time to File the Petition for Writ of Certiorari, extending said time to May 20, 1967. (Appendix C).

Questions Presented.

1. Whether the District Court erred in allowing the Government to prove an understatement of taxable income by use of the bank deposit method, by reason of the fact that the respondent had not established the inaccuracy of the petitioner's books and records—a condition precedent to employing an alternative method of computing taxable income—when the use of the petitioner's books and records was the most accurate manner of ascertaining petitioner's taxable income.

2. Whether the District Court erred in finding sufficient evidence to sustain a finding of wilfulness on the part of the petitioner within the meaning of Title 26, United States Code, Sec. 7201.

Statute Involved.

Title 26, United States Code, Sec. 7201 (Internal Revenue Code of 1954, Sec. 7201).

> "Attempt to Evade or Defeat Tax. Any person who willfully attempts in any manner to evade or defeat any tax imposed by this title or the payment thereof shall, in addition to other penalties provided by law, be guilty of a felony and upon conviction thereof, shall be fined not more than $10,000, or imprisoned not more than 5 years, or both, together with the costs of prosecution."

Statement of the Facts.

Petitioner was an accountant and attorney in pre-World War II, Germany. Immediately before the war, he moved to the United States, and worked as an ac-

countant. Subsequent to World War II, he began filing claims on behalf of Jewish refugees seeking compensation from the German government for war crimes committed in Nazi Germany. The greatest portion of petitioner's income for the years in question was from fees received for filing said claims.

The audit of petitioner's tax returns commenced with a visit from a Revenue Agent in April of 1960 [R. 209]. During the Revenue Agent's initial interview of petitioner, Mr. Roy disclosed that certain receipts were not reported as gross income on his federal income tax returns [R. 210, 211]. This disclosure precipitated an investigation lasting three and one-half years, which led directly to petitioner's indictment and conviction.

The Government's case was based upon the bank deposit method of reconstructing income [R. 343, 344]. The investigating agents at all times asked for records from which they would be able to reconstruct the figures shown on petitioner's income tax return [R. 279, 281, 352]. At no time did they ask for all financial data, or for the books and records which would accurately reflect all receipts during the years in question. The intent of the audit as expressed to petitioner by the investigating agents was a desire to reconstruct petitioner's income as shown on the tax return, rather than attempting to ascertain the total amount of awards received by the petitioner's clients, and the fees received from those awards. The agents

never asked for the records which would disclose taxpayer's true income, and never attempted to determine the existence of same.

The investigating agents were aware of numerous files and file cabinets which contained client accounting cards [R. 214, 218]. The agents did not review said records. They were given the cash receipts book, but only made a few preliminary notes on the figures contained therein [R. 214, 215]. It is undisputed that the investigating agents neither asked for, nor were refused, the client accounting cards, which in fact accurately reflected petitioner's income [R. 227-230, 350].

Petitioner's records were maintained by his secretaries and by his nephew. The secretaries maintained books in which they listed the total amount of recovery awarded for each client [R. 92-99]. This record was maintained for the purpose of assuring that each award was sent to the petitioner, and in effect constituted an accounts receivable journal. Each girl also maintained a cash receipts book wherein she listed the amount of money received and the amount still owed on each account [R. 161-163, 465]. Individual account cards were kept for each client. The cards stated the amount to be received, noted the subsequent costs incurred, and moneys collected [R. 102-4, 161-7, 202-4, 466-7]. The testimony indicates that one of these records were ever destroyed, that they were kept in the ordinary course of business, served as the financial records for the busi-

ness, and that none of the records were ever requested by the investigating agents.

The extensive audit conducted by the investigating agents was not directed toward an examination of the petitioner's "accounting records," but rather was an attempt to independently reconstruct the petitioner's taxable income by means of the bank deposits method. The accounting records enumerated above were not examined and were in fact ignored by the examining agents who chose to reconstruct petitioner's income without first ascertaining if the income was properly reflected in the petitioner's records.

The examining agents (Special Agent Donley and Revenue Agent Breese) testified that they could not be certain whether certain funds deposited in German bank accounts (the deposits relied upon by the Government as establishing fraudulent intent) were subsequently transferred to Los Angeles bank accounts and thereby reflected in the taxpayer's reported gross receipts [R. 226, 344]. The reconstruction of petitioner's income was therefore not only unwarranted but also incomplete and inaccurate.

REASON FOR GRANTING THE WRIT.

A. Judicial Supervision of the Administration of Criminal Justice.

In *McNabb v. United States* (1943), 318 U.S. 332, 341, 63 S. Ct. 608, 613, this Court stated:

> "The principles governing the admissibility of evidence in federal criminal trials have not been restricted, therefore, to those derived solely from the Constitution. In the exercise of its supervisory authority over the administration of criminal justice in the federal courts (citation), this Court has, from the very beginning of its history, formulated rules of evidence to be applied in federal criminal prosecutions. (citations) And in formulating such rules of evidence for federal criminal trials the Court has been guided by considerations of justice not limited to the strict canons of evidentiary relevance."

See also *Ker v. State of California* (1963), 374 U.S. 23, 31, 83 S. Ct. 1623, 1628.

In the case before the Court, if the investigating agents had reviewed and analyzed the available books and records, the entire audit and trial (should the taxpayer have been indicted) would have proceeded in a different fashion. The receipts which were not reflected in the taxpayer's income tax returns would have been ascertained through use of his books and records, and the sole questions before the trial court would have been the taxability of the omitted receipts and the reasons for the omission. The audit would have been completed in a matter of weeks, rather than a matter of years, and the taxpayer would not have been subjected

to the stress and strain accompanying a lengthy Internal Revenue investigation. The procedural safeguard requested by the petitioner—that the investigating agents be required to attempt to determine unreported income by first examining his books and records—would have changed the entire picture painted during the investigation, and viewed during the trial. The petitioner respectfully submits that the law now requires Internal Revenue agents to first examine the taxpayer's books and records which are available before attempting to reconstruct the taxpayer's income, and, that the lower courts have erroneously failed to apply said rule in this case.

B. Holland Case.

The respondent erred in its use of the bank deposits method of computing petitioner's taxable income for the reason that it had not established the *inaccuracy* of the petitioner's books and records, which is a condition precedent to employing an alternative method of computing taxable income. The use of the petitioner's books and records would have been the most accurate manner of ascertaining his taxable income.

Prior to 1954 the case law was unclear when considering the use of circumstantial evidence to establish a tax deficiency and the accompanying fraudulent intent. Circumstantial evidence was presented through recomputations of taxable income by use of the net worth or bank deposits methods. The conditions precedent to the use of those methods, and the evidentiary value of same, had been the object of court decisions which varied greatly in permitting the use of such evidence. The conflict was presumably resolved by the decision of this Court in *Holland v. United States*

(1954), 348 U.S. 121, 75 S. Ct. 127. The Court first noted at pages 124, 125:

> "In recent years, however, tax-evasion convictions obtained under the net worth theory have come here with increasing frequency and left impressions beyond those of previously unrelated petitions. *We concluded that the method involved something more than the ordinary use of circumstantial evidence in the usual criminal case.* Its bearing, therefore, on the safeguards traditionally provided in the administration of criminal justice called for a consideration of the entire theory.
>
> . . .
>
> In a typical net worth prosecution, the Government, *having concluded that the taxpayer's records are inadequate as a basis for determining income tax liability,* attempts to establish an 'opening net worth' or total net value of the taxpayer's assets at the beginning of a given year." (Emphasis added.)

The Court then considered the facts at hand (348 U.S. at 131, 132):

> "Petitioners' accounting system was appropriate for their business purposes; and, admittedly, the Government did not detect any specific false entries therein. Nevertheless, if we believe the Government's evidence, as the jury did, *we must conclude that the defendants' books were more consistent than truthful, and that many items of income had disappeared before they had even reached the recording stage.* . . . To protect the revenue from those who do not render true accounts the government must be free to use all legal evidence available to it *in determining whether the story told by the taxpayer's books actually reflects his financial history.*" (Emphasis added.)

The *Holland* case was both restrictive and liberal in setting standards to be followed in determining taxable income by use of circumstantial evidence. The Court clearly states that the Internal Revenue Service may use circumstantial evidence in cases other than where the taxpayer has no books, or where his books are inadequate (348 U.S., at 131). We believe that the Court in reality said that the net worth method may be used to establish the fact that the taxpayer's books are inaccurate; consistency on its face cannot be equated with accuracy. However, the Court was restrictive in that it set limitations on the use of the net worth method, and throughout the opinion stated that the use of circumstantial evidence in a tax case creates many dangers for the taxpayer.

The Court also notes in *Holland* (75 S. Ct., at 135, 348 U.S., at 135-136) that the Government is required to effectively negate all reasonable explanations by the taxpayer inconsistent with guilt. When the Government fails to show an investigation into the validity of leads, the trial judge may consider them as true and the Government's case insufficient to go to the jury. Can the *Holland* case, while stating that the Government has the burden of investigating all leads furnished by the taxpayer and negating all nontaxable sources of income, also be stating that the investigating agents may recompute and reconstruct the taxpayer's income without referring to, comparing, or contrasting the taxpayer's books and records with the fruit of their independent investigation? Such a holding would be entirely inconsistent with the Court's warnings of the dangers involved when establishing a tax case by use of circumstantial evidence.

C. Dual Purpose of Bank Deposits Method.

The rule of this Court as established in *Holland, supra,* has been often interpreted by the Circuit courts in establishing a two-fold application of the bank deposits method. In *Schwarzkopf v. Commissioner of Internal Revenue* (3rd Cir., 1957), 246 F. 2d 731, 733-734, and in *Hoffman v. Commissioner of Internal Revenue* (3rd Cir., 1962), 298 F. 2d 784, 786, the courts noted that the net worth method serves two purposes: "First, it may be used to test the correctness of the books; secondly, it is cogent evidence of the amount of income which went unreported." *Schwarzkopf v. Commissioner of Internal Revenue, supra.* The Court have been clear to point out that the indirect methods of reconstructing taxable income were to be used only when other methods of disclosing income failed. In light of the dangers of the use of circumstantial evidence in reconstructing taxable income, such method must first be used to test the correctness of the books, and if such test demonstrates that the books are *inaccurate,* it may then be used to reconstruct the correct amount of taxable income.

The philosophy expressed in *Holland, supra,* is that an apparently accurate and consistent set of books and records shall not frustrate the Government's attempt to show that income has been understated. The Government may use the net worth method, or any other method constituting circumstantial evidence first to disprove the accuracy of the taxpayer's books and records. Once the books are demonstrated to be inaccurate, said method of circumstantial evidence may be be used to *approximate* the taxpayer's taxable income. This rule has been expressed in numerous Tax Court decisions, in addition to the statements of the appellate

courts noted above. Where such a rule is accepted in civil cases, its wisdom and desirability are more apparent in criminal actions.

D. "Most Accurate Method" Test.

Petitioner contends that, considering the dangers encountered in prosecuting taxpayers based upon circumstantial evidence, the investigating agents should be required to use that method for determining income which will most accurately reflect, or, if necessary, reconstruct the taxpayer's income. In this case, all income was reflected in petitioner's books and records, and the Government agents, for reasons unknown to petitioner, chose to reconstruct his taxable income by use of the bank deposits method. Under the circumstances of this case, it is clear that the most accurate method for determining petitioner's taxable income for the years in question was through the use of the books and records maintained by petitioner contemporaneous with his business transactions.

The above stated rule has been used as a guideline by the Tax Court, and was also stated in *Blackwell v. United States* (8th Cir., 1957), 244 F. 2d 423, 427-428.

In their extensive research, counsel for petitioner have been able to find but one case in which the taxpayer's books and records were inconsistent with his income tax return. In *Moore v. United States* (5th Cir., 1958), 254 F. 2d 213, the taxpayer claimed that his books and records were in fact inaccurate, and that the net taxable income as shown on his income tax return was correct. The Government attempted to prove its case by basing its understatement of income on the discrepancy between the books and the tax return, in fact

relying upon the books. In this case, the books have been totally ignored.

E. Conclusion.

This case has great importance! It affords this Honorable Court the opportunity to delineate the guidelines for tax investigations of a criminal nature when they deal with "adequate" and "accurate" books and records.

The *Holland* decision permits the Government to proceed on alternate methods of computing taxable income, *i.e.*, net worth and bank deposits, because, though books and records exist, ". . . many items of income had disappeared before they had even reached the recording stage. . . ." and, because the books were ". . . more consistent than truthful."

This is appropriate in its own context. However, where the books and records are adequate and accurate we suggest that alternate methods are not employable. In the case at bar the petitioner, rightly or wrongly, made an allocation between non-taxable and taxable receipts. Other than in 1960, this was not done on the face of the return. However, expenses were similarly allocated, *i.e.*, between deductible and non-deductible—following the same ratio of taxable and non-taxable receipts, and this was revealed within the four corners of the income tax returns. More important, the petitioner voluntarily revealed his treatment and allocation to the revenue agents at the very outset of the audit and investigation.

In this frame of reference, should the Government be permitted to ignore the books and records and conduct a lengthy and unusual (to a taxpayer with adequate and

accurate records) audit and investigation, and further be permitted to use alternate methods fraught with their own dangers?

From the viewpoint of the taxpayer it borders on the incredible for the Government to pursue an investigation that virtually ignores the fountainhead and source of information, namely, the underlying records. This indirect method must breed distrust and creates a charged atmosphere in which cooperation will collapse. Had this audit been properly handled the taxpayer could not have made damaging statements which statements were generated in a hostile environment.

The taxpayer paid salaries to many employees for the principal purpose of having records and data for his own clients; also for the secondary purpose of having a set of books to be audited. To this day no such audit has been conducted by the Government. Unless and until the agents or other professional witnesses of the Government can testify that the records are inadequate and inaccurate, the bank deposits method should not be allowable. The *Holland* case approves of the bootstrap approach, to wit: allowing the use of a circumstantial method to prove its need. However, inherent in that opinion is the underlying assumption that the taxpayer's books and records were unavailable (Fifth Amendment umbrage) or were not truthful. In this regard it was assumed by the *Holland* Court hat the agents audited what records were available. Nothing detracts from the obligations of the agents to audit records maintained in the normal course of business. There is no bootstrap operation in this case; there is rather a unilateral determination to use the bank deposits method nowithstanding the veracity and integrity of the books

and records. In order to avoid paying more than lip service to the fears of the use of circumstantial evidence in a criminal tax case, this Court should clearly reaffirm the proposition that the Government must audit what is available before proceeding to alternate theories.

Aside from the procedural standard requested above, it is apparent that a proper examination of the petitioner's books and records would have revealed the entire amount of omitted income. The difference between the sums shown on the tax return and those reflected in the books and records was explained by the taxpayer in terms of an erroneously believed legal interpretation. With reference to this interpretation, the taxpayer excluded a pro rata proportion of expenses which he felt were attributable to the tax-free income. In an audit conducted in a proper manner, the discussions with the taxpayer are minimal, if any, and the Government would be hard-pressed to even establish civil fraud. The whole area of intent would remain limited to belief at the time the return was filed, rather then being extrapolated from post-return discussions unnecessarily generated by a reconstruction of taxable income.

The bank deposits method is not a substitute for primary auditing. Taxpayers should be protected from lengthy harassment, however inadvertent, necessitated every time indirect methods of audit are employed.

In granting this Writ, the Court may consider whether the voluntary disclosure of an omission of receipts from the tax return gives cause for a reconstruction of taxable income without first ascertaining the accuracy or lack thereof of the taxpayer's books and

records. With the great number of tax investigations now being conducted, such guidelines should be clearly established so that taxpayers will not be denied procedural safeguards during a tax investigation.

For the foregoing reasons, this petition for a Writ of Certiorari should be granted.

Respectfully submitted,

HOCHMAN & SALKIN,
By BRUCE I. HOCHMAN,
HARVEY D. TACK,
Attorneys for Petitioner.

Of Counsel:
BURTON MARKS.